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International financial system and development

Report of the Secretary-General

Summary

The present report, submitted in response to General Assembly resolution 64/190, complements the report of the Secretary-General on the follow-up to and implementation of the Monterrey Consensus and the Doha Declaration on Financing for Development. It reviews recent trends in the net transfer of financial resources to developing countries and current efforts to reform the international monetary and financial system and architecture. The report highlights the urgent challenges arising from the world financial and economic crisis and its impact on development, in particular in the key areas of financial regulation and supervision, multilateral surveillance, macroeconomic policy coordination, a global financial safety net, the international reserve system and governance reform of the Bretton Woods institutions.

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I. Net transfer of financial resources of developing and transition economies

1. The world financial and economic crisis has highlighted the weaknesses of the international financial system in terms of underpinning financial stability and mobilizing financial resources for development. While international financial liberalization has increased the access of developing countries to financial resources, the procyclical, boom — bust cycles of private capital flows have not delivered the stable supply of financing that is needed. Rather, the crisis has posed serious challenges to the capacity of national macroeconomic policies to mitigate financial volatility and prevent spillover of problems to the real economy. Countries have also had to incur the burden of accumulating foreign reserve holdings to provide self-insurance against external shocks.

A. Lower net outward resource transfers from developing countries in 2009

2. Developing countries as a group continued to provide net financial resources to developed countries in 2009, amounting to $513 billion. While still substantial, this amount is notably lower than the record high of $883 billion reached in 2008 (see annex). The decrease reflects the transitory narrowing of global imbalances as a consequence of the global economic and financial crisis. The structure of flows underlying the reversal of the increase in financial transfers in 2009 indicates, for the most part, a disorderly unwinding of accumulated global imbalances.

3. The impact of the global financial crisis and its aftermath has affected net financial transfers from developing countries in all regions of the developing world. Western Asia experienced the strongest decline in net resource transfers in 2009, reflected in much lower oil export revenues and by countries in the region drawing on international reserves to compensate for the fall in external demand. In Latin America and the Caribbean, the value of export earnings declined in line with the contraction of world trade in goods in 2009. Negative net transfers in East and South Asia declined modestly in 2009 with the narrowing of the current account surplus. Net transfers from countries with economies in transition decreased from just over $150 billion in 2008 to $80 billion in 2009, reflecting weak exports and a deterioration of the current account balance.

4. The structural problems underlying the emergence of global imbalances persist and the current path of global recovery is expected to result in a reversal to increased macroeconomic imbalances (see E/2010/73). This is mirrored by an expected increase in outward resource transfer from developing countries in 2010. After the end of fiscal stimulus and a rebalancing from public expenditure to private investment and consumption, it is expected that a still-large Government deficit of the United States of America will likely increase that country's external deficit. Similarly, the external balance of the European Union may also be expected to increase in 2010. In Asia in particular, relatively weak domestic demand has not fundamentally changed, in spite of recently announced changes in exchange rate policy and measures to stimulate domestic consumption. Therefore, significant time and investment will be required to achieve structural changes to move away from a high dependence on exports for growth. The potential increase in global imbalances

in the context of slowing economic recovery and mounting public indebtedness in the major economies elevate the risks of exchange-rate and financial market volatility.

5. Developing countries have continued to accumulate foreign reserves to insure against financial shocks. Despite the effective use by emerging market economies of this buffer against the impact of the financial crisis, the disorderly unwinding of global imbalances during the financial crisis highlights the importance of building a global financial safety net (see sect. II.C below).

B. Recovery of private capital inflows to developing countries

6. Owing to the effects of the turbulence in global financial markets, the levels of net private capital flows to developing countries have fallen sharply during the past two years. There has been a strong recovery in inflows since 2009 however, especially to some emerging economies. Nevertheless, despite these signs of resurgence, the overall magnitude of international private capital flowing into developing countries remains well below the peak registered in 2007.

7. The rebound in private capital inflows has been aided by policy measures to recapitalize financial institutions and stabilize markets, as well as by rapid growth and buoyant stock markets in some emerging economies. Moreover, the crisis also seems to have altered perceptions regarding the relative risk characteristics of emerging markets and advanced economies. It has been argued that, owing to debt problems in a number of advanced economies in Europe, the perceptions of investors about sovereign credit risks have moved in favour of emerging economies.[1] As a result, the Emerging Markets Bond Index Global (EMBIG) yield spread index has narrowed from close to 470 basis points in mid-2009 to about 330 basis points in mid-2010.[2] Despite this, any upturn in private capital flows to developing countries would be limited by factors such as higher asset valuations in some emerging markets and relatively muted demand for external borrowing in some emerging economies, especially in Asia, because of relatively low domestic interest rates.[3]

8. The impact of the global economic crisis on private capital flows to Africa has been relatively limited, as risks in the majority of financial markets in the region tend to be uncorrelated with those in the advanced economies. Inflows of foreign direct investment (FDI) to Africa reached record levels in 2008, but declined in 2009.[4] Most of these flows have gone into the natural-resource sector in commodity-rich countries. There has been a strong recovery in private capital flows into East and South Asia over the past year, led by an upturn in portfolio flows and bank lending. There are signs of stabilization in net private capital flows to Latin America, led in particular by a rebound in portfolio investment. After the sharp reversal of a massive increase in credit flows to Western Asia in 2008, inflows remained weak in 2009, owing to large net repayments to banks by some States.

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[1] International Monetary Fund, *Global Financial Stability Report: Meeting New Challenges to Stability and Building a Safer System* (Washington, D.C., April 2010); World Bank, *Global Economic Prospects Summer 2010: Fiscal Headwinds and Recovery* (Washington, D.C., 2010).

[2] J.P. Morgan Chase database (www.morganmarkets.com).

[3] Institute of International Finance, "Capital flows to emerging market economies", April, 2010.

[4] *World Economic Situation and Prospects 2010* (United Nations publication, Sales No. E.10.II.C.2).

9. Flows of FDI remain the largest component of private resource flows to developing countries, despite a considerable decline in inflows in 2009. The crisis has had a negative impact on FDI through reduced access to finance for firms that are investing and by affecting investor confidence as a result of gloomy economic prospects and market conditions. All regions have experienced a decline in FDI inflows. Any recovery of FDI inflows is expected to be curbed by a muted desire on the part of firms for cross-border mergers and acquisitions and for green-field development.[5]

10. Bank lending continues to be subdued as a result of persistent deleveraging by international banks. Conditions are especially muted in the transition economies of Europe and Central Asia, where mounting non-performing loans are likely to restrain lending.[6] Portfolio investment flows to developing countries also declined markedly during the crisis, although there has been a recovery in capital movements to some countries in Asia and Latin America that are viewed as having better growth prospects. In general, there are signs of a strong improvement in the cost and availability of debt financing in emerging countries. Emerging market corporate and sovereign bonds have been issued at a record pace in the first half of 2010, with particularly strong growth in corporate borrowing, led by companies from China.

11. There are a number of sources of risk that could depress levels of private capital flows to developing countries. A renewed downturn in the global economy may affect flows of capital to the developing world. A dampening of global economic activity could also take place as the effects of stimulus measures wear off in a number of countries. In addition, a recovery in investor appetite for emerging-market risk could increase short-term capital flows to certain countries, which may give rise to inflationary pressures and new asset price bubbles. In this regard, there has been discussion on the use of policy tools, including capital controls, to limit the volatility of short-term capital flows. A number of countries, such as Indonesia and the Republic of Korea, announced capital controls to regulate speculative capital inflows. In October 2009, Brazil instituted a 2 per cent tax on capital inflows to portfolio investments in equity and debt. The issue was discussed at the June 2010 meeting of Group of 20 (G-20) finance ministers in the Republic of Korea.

C. Official development assistance falls short of targets

12. While official development assistance (ODA) grew slightly in real terms from 2008 to 2009, it is projected to fall short of existing internationally agreed aid commitments for 2010.[7] Total net ODA from Organization for Economic Cooperation and Development (OECD) Development Assistance Committee (DAC) member countries rose slightly, by 0.7 per cent in real terms from 2008 to 2009, to reach $119.6 billion, constituting 0.31 per cent of their combined gross national income (GNI) in 2009. Net ODA to Africa was $27 billion in 2009, including $24 billion channelled to sub-Saharan Africa, representing an increase of 3 per cent and 5.1 per cent, respectively, over 2008.

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[5] IMF, *Global Financial Stability Report* (2010).

[6] World Bank, *Global Economic Prospects* (2010).

[7] Organization for Economic Cooperation and Development, "Development aid rose in 2009 and most donors will meet 2010 aid targets", 14 April 2010, available from http://www.oecd.org.

13. Net ODA from the United States increased by 5.4 per cent in real terms from 2008 to 2009 and reached $28.7 billion, representing 0.20 per cent of its GNI. In 2009, the United States increased its ODA to sub-Saharan Africa by 10.5 per cent to $7.5 billion and to least developed countries by 13.6 per cent to $8.1 billion. Thus, the United States delivered on its pledge to double its aid to sub-Saharan Africa between 2004 and 2010 ahead of schedule. The combined net ODA from 15 DAC European Union members fell by 0.2 per cent to $67.1 billion in 2009, however, while their ODA/GNI ratio rose marginally to 0.44 per cent following a decline in GNI resulting from the economic contraction in much of the region. The net ODA of Japan also fell by 10.7 per cent in real terms to $9.5 billion, with a marginal decline of its ODA/GNI ratio to 0.18 per cent in 2009. As a result, Japan fell short by $3.6 billion in delivering on its commitment to increase ODA by $10 billion from 2005 to 2009.

14. Pledges to provide ODA made at the Gleneagles summit of the Group of Eight (G-8) and other international forums implied lifting ODA from about $80 billion in 2004 to nearly $130 billion (in 2004 prices) in 2010, or 0.36 per cent of the combined GNI of DAC member States. Taking into account the negative impact of the global financial crisis on donor GNI, OECD has revised the dollar value of the target for 2010 down to $126 billion (in 2004 prices).

15. While most DAC member States have maintained their 2010 commitments, some of them, including some large donors, have reduced their pledges or postponed their target dates. Hence, net ODA for 2010 is estimated at $108 billion (in 2004 prices), constituting 0.32 per cent of combined donor GNI. This level of ODA represents an expected shortfall of $18 billion (in 2004 prices) against the revised 2005 commitment, and $22 billion below the original target. The shortfall is particularly glaring in ODA to Africa, which is now estimated to be $11 billion against the initially pledged $25 billion for 2010. This is attributable to some European donors, who allocate large shares of their ODA to Africa, not meeting their targets pledged at the Gleneagles G-8 summit. This ODA delivery gap is a serious threat to efforts to accelerate achievement of the Millennium Development Goals in low-income countries in Africa.

16. In June 2010, heads of State and Government of the European Union reaffirmed their commitment to reach a collective ODA/GNI ratio of 0.7 per cent by 2015. They also decided to evaluate annual progress achieved on aid targets. Leaders of the G-8 and G-20, at their respective summits in June 2010, agreed to reinforce their efforts to meet the Millennium Development Goals, including through the use of ODA.[8] The G-8 members, in cooperation with a number of other Governments, international foundations and health organizations, launched the Muskoka Initiative to accelerate progress towards Goals 4 and 5. Significantly more than $10 billion is expected to be mobilized through the Initiative over the period 2010 to 2015.

[8] G-20 Toronto Summit Declaration, 26 and 27 June 2010, available from http://g20.gc.ca; and G-8 Muskoka Declaration: Recovery and New Beginnings, Muskoka, Canada, 25 and 26 June 2010.

II. Strengthening the international financial architecture

17. The international community has continued its efforts to overhaul financial regulation and supervision, as well as to review the mandate and responsibilities of the International Monetary Fund (IMF) over surveillance, financing and stability of the international monetary system, including the international reserve system. In addition, there have been further developments in governance reform of international financial institutions to enhance their legitimacy, credibility and effectiveness.

A. Reform of financial regulation

18. The financial crisis has demonstrated an urgent need to significantly improve financial regulation and supervision to achieve global financial stability. In this regard, the Conference on the World Financial and Economic Crisis and Its Impact on Development called for expanding the scope of regulation and supervision and making it more effective with respect to all major financial centres, instruments and actors.

19. The major step in the reform process is the modification of the Basel II framework for capital and liquidity regulation. The package of reform proposals was released in December 2009 and its gradual implementation is expected to start at the end of 2012. It has been agreed that phase-in arrangements to adopt the new standards should reflect different national starting points and circumstances.[9]

20. According to the proposals, the level, quality, consistency and transparency of bank capital will be raised. Market pressure and bank supervisors have already forced banks to increase their capital and liquidity buffers beyond those required by the current Basel II framework. Nevertheless, significantly higher formal minimum capital requirements are considered necessary to help contain any return to the unacceptably low pre-crisis capital and liquidity levels when financial conditions return to normal and competitive pressures reassert themselves.

21. There is also an agreement to introduce a leverage ratio, that is a cap on the amount of assets a bank can have in relation to its equity. This is seen as a supplementary backstop to the risk-based capital framework. In addition, there will be higher capital charges related to bank trading activities, complex securitizations and derivatives.

22. Along with more and better capital to absorb unexpected losses, the Basel Committee on Banking Supervision has proposed a global liquidity standard that would require banks to better match the maturities of their assets and liabilities. Another feature of this standard is the requirement for banks to hold a sufficient stock of high-quality liquid assets to allow them to survive a 30-day loss of access to funding markets.

23. Higher capital requirements would force banks to raise additional capital. In this regard, there have been concerns that this may have a negative impact on the ability of banks to lend and result in somewhat slower global growth, at least in the short term. However, according to preliminary findings of a group of experts drawn

[9] G-20 Toronto Summit Declaration.

by the Bank for International Settlements from 14 countries, the European Central Bank, the European Union and the Bank itself, the impact on gross domestic product (GDP) is likely to be mild and much less than existing GDP forecast errors. At the same time, these modest costs will likely be offset by reduced volatility in GDP, less frequent crises and lower risk premiums.[10] Nevertheless, revised standards and their implementation should be flexible enough to take into account domestic circumstances. In particular, special attention needs to be given to the characteristics, depth and capacity of local financial markets in developing countries.

24. In addition, work is under way to achieve a single set of global accounting standards and on internationally consistent implementation of agreed measures to improve transparency and introduce regulation and supervision of hedge funds, credit rating agencies, compensation practices and over-the-counter derivatives. Close cooperation and coordination among numerous national and international regulatory and standard-setting bodies is important to ensure coherence and consistency of financial reform measures and to assess the costs and benefits of the proposed changes.

25. Macroprudential regulation is supposed to deal with two major issues: the procyclicality of the financial system, and systemic risk and moral hazard caused by systemically important financial institutions that are considered "too big to fail". To address procyclicality, the Basel Committee has proposed, beginning with large and connected financial firms, building up additional countercyclical buffers through a combination of countercyclical capital charges, forward-looking provisioning and capital conservation measures. These buffers should be built up in good times and run down in bad, allowing the financial system to absorb emerging strains more easily and dampen amplification mechanisms.

26. In the treatment of systemic institutions that are "too big to fail", work is under way on a harmonized international regulatory framework for internationally active banks. This is considered one of the major concerns of regulatory reform, as the crisis has demonstrated an alarming disparity between the global activities of these banks and the constraints of mostly national regulation. The starting point is to identify systemically important institutions, as size is not always the sole indication of systemic relevance. Interconnectedness, substitutability and the state of the markets are also essential factors. However, no agreement has yet been reached on the issue.[11]

27. As for ensuring the safety and soundness of globally active financial institutions, the reform of the Basel II framework and resulting improvement of the capacity of systemically important institutions to absorb losses are considered to be only part of the solution to this problem. Other proposed measures include systemic-risk-based capital surcharges and levies that are related to the contribution of institutions to systemic risk, enhanced on-site supervision, harmonized enforcement

[10] "Current efforts to enhance global financial supervision", remarks by Stephen Cecchetti, Economic Adviser and Head of the Monetary and Economic Department, Bank for International Settlements, at the Federal Reserve Bank of San Francisco Asia Banking and Finance Conference, 7 and 8 June 2010, available from www.bis.org.

[11] "The G20 agenda on financial regulation", speech by Axel A. Weber, President of the Deutsche Bundesbank, at the International Conference on Financial Market Regulation, Berlin, 19 May 2010, available from www.bundesbank.de.

activities and strengthened supervisory cooperation and coordination, including supervisory colleges.

28. Another important focus of reform is the development of legal and policy frameworks for cross-border resolution that should allow institutions of all types and sizes to fail without putting the rest of the financial system or the taxpayers at risk. Some alternative solutions that may gain broader acceptance include placing restrictions on certain business activities and on the size and structure of financial firms that would make all institutions resolvable without adverse systemic implications.

29. Options to devise a fair and substantial contribution from the financial sector to fund the fiscal costs of financial failures are also being explored internationally. The discussion was initially centred around the imposition of levies and taxes on financial institutions, but global bank taxation lacked the necessary support. Accordingly, it is now recognized that there is a range of policy options and that countries are pursuing different approaches.[12]

30. The crisis has shown that monetary and fiscal policies also matter in helping to mitigate the build-up of financial imbalances. According to many observers,[13] along with controlling inflation, monetary policy should take better account of asset prices and credit booms. Fiscal policy must play a supporting role in a financial stability framework. While the major goal of fiscal policy is countercyclical demand management, it should also take into account the need to build fiscal buffers in good times that allow a response to financial system stress.

B. Multilateral surveillance and policy coordination

31. The IMF has recognized that, while the outside world has changed, the surveillance carried out by the Fund and its members has not changed much since the late 1970s.[14] The crisis has, however, forcefully demonstrated that in a world of integrated capital markets and interconnected national financial sectors the status quo is no longer acceptable. A key goal in reform is therefore to strengthen multilateral surveillance and enhance the coverage and depth of analysis of financial sector issues and policies. To promote global stability, surveillance activities by IMF need to pay more attention to policy spillovers, especially those of countries that are systemically important. Surveillance at the country level remains fundamental but no longer suffices. Assessing international coherence and promoting coordination among national policies should become a central objective of the collaboration.

32. According to the IMF Independent Evaluation Office, most members support a greater direct Fund involvement in international policy coordination and spillover analysis.[15] However, the role of the Fund is not well defined and, therefore, it is

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[12] G-20 Toronto Summit Declaration.

[13] See, for instance, "Towards a global financial stability framework", statement by Hervé Hannon, Deputy General Manager, Bank for International Settlements, at the forty-fifth SEACEN Governors' Conference, Cambodia, 26 and 27 February 2010, pp. 19-23, available from www.bis.org.

[14] IMF, "Modernizing the surveillance mandate and modalities", 26 March 2010, p. 4, available from www.imf.org.

[15] IMF, Independent Evaluation Office, "IMF interactions with member countries", 25 November 2009, p. 34, available from www.imf.org.

considered useful to clarify what is expected of the Fund and its membership to preserve systemic stability, including key modalities, procedures and outcomes. There have been suggestions to discuss the possibilities of producing reports on outward spillovers for countries whose policies or circumstances may significantly affect the stability of the system, as well as of holding multilateral consultations, as needed, on specific topics that have systemic implications in order to foster collaboration and collective action.[16] One such topic could be the growing developed country sovereign risks which, according to IMF, have become the newest threat to the global financial system.[17] It is considered necessary to strengthen surveillance of developed country fiscal policies and their impact on international interest rates, exchange rates and capital flows, including private and public financing in developing countries.[18]

33. Thus far, the major attempt at the highest political level to take account of multilateral dimensions when setting national policies has been made outside of the surveillance process at IMF. At their summit in Pittsburgh in September 2009, G-20 leaders announced the Framework for Strong, Sustainable and Balanced Growth and committed themselves to submitting their actions to peer review in a mutual assessment process. The first stage of the assessment process was completed before the G-20 summit in Toronto.

34. The IMF has been asked to assist this effort by providing an analysis of how the G-20 policies fit together and whether those policies are consistent with more sustainable and balanced global growth. This holds out some prospects of greater engagement by systemically important countries with the Fund, including in ways that are representative of the whole IMF membership who are affected by spillovers from the process. Also, the involvement of the Fund in the mutual assessment process could inform the discussion on surveillance reform.

35. The substitution of the G-20 for the G-8 as the major forum for global discussions on international economic cooperation is a welcome development. However, the majority of United Nations Member States are still excluded. It is necessary for the G-20 process to develop greater legitimacy, including through forging stronger institutional linkages with non-member States and developing constructive dialogue with universal international bodies, such as the United Nations, to ensure that the views and concerns of all countries, especially the poorest, are taken into account.

36. An initiative aimed at developing such a dialogue on coordination and cooperation between G-20 and non-G-20 members is the formation of the informal Global Governance Group, comprising 24 United Nations Member States. The Group underscores that, given the complexities and interdependencies of the global economy, it is important for the G-20 to be consultative, inclusive and transparent in its deliberations for its outcomes to be effectively implemented on a global scale. The Group has put forward several ideas on how to improve engagement between

[16] IMF, "Executive Board discusses modernizing the surveillance mandate and modalities and financial sector surveillance and the mandate of the Fund" (22 April 2010), available from www.imf.org.

[17] James Rowe, "Government borrowing is rising risk to world financial system", *IMF Survey* online, 20 April 2010, available from www.imf.org.

[18] IMF, International Monetary and Financial Committee, 21st meeting, 24 April 2010, statement by Zhou Xiaochuan, Governor, People's Bank of China, available from www.imf.org.

the G-20 and the United Nations through regular and predictable channels. It has also proposed to allow non-G-20 countries to participate in G-20 ministerial gatherings and senior level and expert working groups on specialized issues (see A/64/706, annex).

37. Achieving more sustainable and balanced global growth will also require close coordination of macroeconomic policy decisions with other areas of global governance, including those related to the multilateral trading system; aid architecture; the poverty eradication and sustainable development agenda; and climate change. No specific mechanism to promote coherent policy responses to these interdependent issues exists at present. A strengthened United Nations framework for enhancing coordination and complementarity should be at the centre of efforts to bridge this gap. For instance, there has been a proposal to create within the United Nations a global economic coordination council, which would promote development, seek consistency of policy goals and policies of major international organizations and support consensus building among Governments on efficient and effective solutions for global economic, social and environmental issues.[19]

38. The global financial crisis has revealed the critical importance of enhancing the coverage and depth of analysis of financial sector issues in Fund surveillance. It has been recognized that to better understand and assess the risks of transmission of macrofinancial instability across countries, the Fund would need closer engagement with members with systemically important financial sectors and also with large and complex financial institutions. It has also been suggested to make the Financial Sector Assessment Programme a mandatory part of surveillance, at least for systemically important countries.

39. Financial sector surveillance is not the purview of IMF alone. There is a need for closer collaboration with the Financial Stability Board, the Bank for International Settlements and financial sector standard-setting bodies. The enhanced collaboration should help to avoid excessive duplication, as well as to develop division of labour and a clearer delineation of responsibilities with each party making the most of its comparative advantage.

40. There is also a need to revise analysis and policy prescriptions in cross-border capital flows. Low interest rates and highly liquid conditions in developed countries, the result of monetary policy measures undertaken to forestall the crisis, have led to surges of capital flows to many emerging market economies with comparatively higher interest rates and stronger growth outlook. Sudden inflow surges complicate macroeconomic management and may lead to inflation and asset price bubbles. Also, there are risks of abrupt stops or reversals in those flows. When macroeconomic and prudential policy measures to deal with the problem are not sufficient, it is deemed appropriate to consider imposing controls on capital inflows.[20]

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[19] United Nations, "Report of the Commission of Experts of the President of the United Nations General Assembly on reforms of the international monetary and financial system", 21 September 2009, paras. 25 and 26, available from www.un.org.

[20] "Early warning systems and their role in surveillance", keynote address by Takatoshi Kato, Deputy Managing Director, IMF, at a high-level seminar in Singapore, 9 February 2010, available from www.imf.org.

41. The Fund could provide much needed multilateral perspective on the issue by advising both capital-exporting and capital-importing countries on economic policy choices necessary for ensuring orderly capital flows. Such a multilateral platform on managing capital flows will be an appropriate response to the current crisis, which underscored once again the capriciousness of capital flows.

42. Despite expanding the Fund's surveillance mandate there is a general concern that surveillance does not have enough traction in member countries and IMF surveillance can only be effective to the extent that members are cooperative and responsive. The challenge is to ensure that, going forward, the international community will be more willing and able to respond to global risks in a more coordinated fashion.

C. Global financial safety net

43. Alongside prudential regulation and surveillance, an effective global financial safety net is an important backstop for the preservation of global economic and financial stability. The multilateral safety net was strengthened significantly during the recent crisis through $350 billion in capital increases for the multilateral development banks, reform of IMF credit facilities and the commitment to treble IMF resources. The Fund's role is increasingly seen as a provider of insurance-like crisis prevention facilities amid volatile cross-border capital flows and the risk of contagion.[21] In March 2009, the Fund introduced the flexible credit line to provide timely and upfront support with no ex-post conditions to countries with sound economic fundamentals and policies. There is ongoing discussion on how to make the flexible credit line more useful, including by extending its duration and scope and by making qualification more predictable.

44. For those countries that do not qualify for the flexible credit line but have only moderate vulnerabilities there have been proposals to develop an effective contingent crisis-prevention instrument with elements of predictability and automaticity by modifying the existing high access precautionary arrangement. This new crisis prevention instrument, the precautionary credit line, would provide upfront access to financing as in the flexible credit line, but would allow for some policy conditionality. However, there have been some concerns that the introduction of the precautionary credit line may reduce the attractiveness of the high access precautionary arrangement, increase the complexity of the lending toolkit and lead to an undesirable segregation of members.[22]

45. Another more ambitious proposal, discussed at IMF, calls for the creation of a central-bank-like mechanism, a multi-currency swap line. This mechanism would complement central bank swap facilities by protecting countries from systemic liquidity shock. Given the global reach of systemic crisis and the ad hoc nature of national central bank responses there may be a case for a global, transparent and predictable standing liquidity facility.

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[21] See, for instance, "Systemic challenges for global finance and priorities for reform", remarks by John Lipsky, First Deputy Managing Director, IMF, at a seminar on 18 May 2010, available from www.imf.org.

[22] IMF, "The Fund's mandate: future financing role", Public Information Notice No. 10/51, 22 April 2010, available from www.imf.org.

46. To effectively anchor the global financial safety net, IMF needs adequate financing. In 2009, it was decided to triple its resources to over $850 billion. However, this amount as a share of global GDP is still smaller than it was when the Fund was created, as the Fund's quota-based resources have not kept pace with developments in the world economy. As a result, supporting its members during the recent crisis required recourse to bilateral loan agreements and prompted the expansion of the new arrangements to borrow.

47. The Fund is a quota-based institution, and quotas should be its primary resource. Consequently, the outcome of the fourteenth general quota review, scheduled to be completed in January 2011, should restore the central role of general resources through a substantial increase in IMF quotas. Such an increase would be consistent with the expansion of world GDP, trade and financial flows since the last general quota review in 1998.

48. In exceptional crisis situations, like the one recently experienced, IMF can and should resort to borrowed resources, be they bilateral, or preferably multilateral, through the expanded and enlarged new arrangements to borrow. The new and expanded arrangements should be seen as a backstop against extreme situations and not as a major source of Fund resources. Their activation must remain the exception, not the rule. In this regard, it has been suggested that part of the next quota increase may come from a conversion of contributions to the new arrangements to borrow into quotas.[23]

49. A broader financial safety net at the global level also includes self-insurance through reserve accumulation, bilateral foreign exchange swap arrangements among major central banks and regional reserve pools. There have been discussions on how to improve the coordination and collaboration among IMF, central banks and regional financial arrangements in case of market stress. For instance, during the current crisis, Latin American regional and subregional financial institutions played a significant role in the region by providing credit under more flexible conditions, particularly in helping to finance liquidity needs of small countries. The Chiang Mai Initiative Multilateralization Agreement between members of the Association of Southeast Asian Nations plus China, Japan and the Republic of Korea for a total of $120 billion credit lines, which was developed from the Chiang Mai Initiative bilateral swap network, came into effect in March 2010. It has also been emphasized that the recent actions taken to strengthen economic and financial stability in the euro area by using a combination of insurance options may be a model for future cooperation.[24]

50. To address sovereign risk, European leaders announced on 10 May 2010 the establishment of a European financial stabilization mechanism that would be based on up to $77 billion in European Union funding and a special purpose vehicle that could raise up to $568 billion in additional funds in capital markets with guarantees provided by the euro-area member Governments. The IMF agreed to cooperate with the European Union, if requested by euro-area members. Total available support through loans and credit lines, including potential IMF loans to member countries (up to $284 billion), could be as large as $930 billion. Upon request in individual country cases, IMF is ready to provide financial assistance in parallel with the

[23] IMF, International Monetary and Financial Committee, 21st Meeting, 24 April 2010, statement by Guido Mantega, Minister of Finance of Brazil, available from www.imf.org.

[24] IMF survey online, 11 May 2010, available from www.imf.org.

European Union, similar to co-financing already provided to Hungary, Latvia, Romania and Greece.

51. To address market liquidity, the European Central Bank announced that it was prepared to purchase Government and private debt securities. The Bank also expanded its liquidity provision facilities. In addition, to forestall an emerging shortage of dollar liquidity, the United States Federal Reserve reopened temporary United States dollar liquidity swap lines with the European Central Bank and other major central banks.

52. The initiatives to strengthen the global safety net are unlikely to radically change incentives for countries to accumulate reserves that remain their first line of defence against potential shocks. Reserve accumulation has been an effective option for emerging market economies to protect them from the crisis. During the crisis, central banks in many emerging and some developed countries used part of their reserves to ease domestic tensions created by dollar liquidity shortages. It is hardly possible that, in the foreseeable future, countries will have automatic access to a sufficient quantity of foreign currency funding to cope with a major crisis. Consequently, countries will continue holding some reserves of their own and it has been argued that there are strong indications that reserve accumulation will persist, or even be amplified, following the crisis.[25] The practice of relying to varying degrees on a mix of complementary self-insurance and bilateral and multilateral agreements will likely continue.

D. International reserve system

53. At its meeting in April 2010, the International Monetary and Financial Committee called on IMF "to study the policy options to promote long-term stability and the proper functioning of the international monetary system".[26] Much of the debate surrounding the international monetary regime in which one national currency, the United States dollar, serves as a primary international reserve asset. According to many observers, the current international reserve system was an important element in the absence of smooth adjustment to imbalances, volatile capital flows and lopsided provision of liquidity.[27] The need to reform the international reserve system is now broadly acknowledged.

54. There have been suggestions to move towards a system based on several, competing national currencies performing reserve functions on a more or less equal footing. However, there are few alternatives, if any, that are readily available to assume a reserve role comparable to that of the United States dollar. Besides, such a system may result in even higher exchange rate volatility owing to the possibility of

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[25] "An international financial architecture for the twenty-first century: some thoughts", remarks by Jean-Pierre Landau, Second Deputy Governor of the Bank of France, at the seventeenth Central Banking Seminar of the Bank of Korea, Seoul, 1 June 2010, p. 6, available from www.bis.org.

[26] Communiqué of the twenty-first meeting of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, 24 April 2010, available from www.imf.org.

[27] See, for instance, concluding remarks by Dominique Strauss-Kahn, IMF Managing Director, at the High-level Conference on the International Monetary System, Zurich, Switzerland, 11 May 2010, available from www.imf.org.

sharp shifts of international demand from one international currency to another, since they are likely to be close substitutes.

55. A more modest solution could be for countries with surplus savings to expand the range of their own safe and liquid financial assets available to domestic and international investors. This would raise efficiency of domestic financing, provide investors with a broader range of choices and reduce incentives to export capital in order to protect its value. Another option is the introduction of a new global reserve currency issued by a global central bank. The establishment of a full-fledged international currency, though, requires far-reaching changes, including giving up national sovereignty over key issues of economic policy, which the international community is not yet ready to make. Nevertheless, the international community should continue discussions on future needs and parameters of the global financial system.

56. A more realistic way of reform may be to broaden existing arrangements for special drawing rights (SDRs) which could over time evolve into a widely accepted world reserve currency. This may also require broadening the composition of the SDR basket to make it more representative. All the component currencies, however, should be fully convertible and have well-developed financial markets. Along with reducing the inherent instability of the current system, the greater use of SDRs may result in more democratic control of global liquidity.

57. In August 2009, for the first time since the late 1960s, IMF member Governments took a decision on a general SDR allocation by IMF equivalent to $250 billion. This will be complemented by a network of voluntary arrangements allowing SDRs to be effectively traded between members. Together with the special one-time allocation of about $33 billion in September 2009, the outstanding stock of SDRs increased nearly tenfold from about $33 billion to about $321 billion.[28] Nevertheless, after this increase, SDRs represent less than 5 per cent of global foreign exchange reserves. As not all members need to increase their international reserves, the Fund should explore mechanisms to redistribute SDRs to countries most in need, especially in times of crisis. There is also merit in making SDR allocations when a crisis occurs, with subsequent cancellation once the crisis has passed. The crisis allocations should not be linked to individual country situations, but to systemic risk stemming from liquidity shocks of global or regional scale.

58. For SDRs to take on a significant role, their issuance should be done on a regular basis and possibly linked to the estimated additional long-term demand for foreign reserves. Their use in international trade and financial transactions, as well as in a functioning settlement system to facilitate the direct exchange of SDR claims into all constituent currencies, needs to be enhanced. Thus far, a private SDR market has not taken off. Reaching a critical mass that would allow the development of a deep, diversified and liquid market for SDR instruments would likely be impossible without strong support from the public sector. This can involve some actions that were used to foster the development of the European currency unit market, including issuing SDR-denominated debt by national Governments and multilateral institutions.[29]

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[28] IMF Fact sheet, "Special drawing rights", January 2010, available from www.imf.org.

[29] "The global crisis and the future of the international monetary system", speech by Fabrizio Saccomanni, Director General of the Bank of Italy, at the Chinese Academy of Social Sciences, Beijing, 15 April 2010, available from www.bis.org.

59. Additionally, it may be necessary to establish at IMF SDR-denominated reserve accounts that would allow large reserve holders to exchange their currency reserves for SDR-denominated securities and deposits, without undesirable exchange rate effects. The resulting shift of the exchange rate risk from the original holders of currency reserves to other parties will require an agreement on an appropriate burden-sharing arrangement. This issue was discussed when the substitution account was negotiated within IMF more than a quarter of a century ago.

60. Past experience suggests that any reform of the current international reserve system should be a part of a broader framework. Indeed, it is not likely that any feasible reform would bring about smooth and automatic balance of payments adjustment. For instance, it has been argued that while reserve alternatives would increase pressure on the United States to adjust, incentives for the surplus countries would not change much.[30] Therefore, along with moving towards greater reserve options, policy dialogue and cooperation aimed at more balanced and sustainable global growth will still remain indispensable.

E. Governance reform at the Bretton Woods institutions

61. Addressing global economic governance issues is a prerequisite for all other changes in the international financial architecture. International financial institutions need a more representative, responsive and accountable governance, reflecting the realities of the twenty-first century. Both IMF and the World Bank have taken important steps to redress imbalances in terms of voice and representation.

62. At its meeting in October 2009, the International Monetary and Financial Committee agreed to shift at least 5 per cent of aggregate quota shares in IMF from developed to developing and transition economies using the current quota formula as the basis, and reiterated its commitment to protect the voting share of the poorest members. The quota review should be completed before January 2011. Other governance reforms are under way, including greater political involvement in the strategic oversight of IMF; the Executive Board composition and size and ways of enhancing its effectiveness; voting procedures, including special majorities; selection of senior management; and staff diversity.

63. Aligning quota shares with weight in the world economy is the principal governance challenge for IMF. Many issues still need to be resolved, including differences related to the broad goals of quota realignment. Indeed, it is not yet clear whether the shift in quota shares should be only to dynamic emerging market and developing countries or to all underrepresented countries. Also, there is no consensus on the size of the shift. In this regard, many developing countries are of the view that the shift should be of at least 7 per cent. Moreover, there is no clarity on how to protect the voting power of poorest countries — by a further increase in basic votes or through ad hoc quota allocations. Finally, there is no clarity on how many countries should be protected — all Poverty Reduction and Growth Facility eligible countries or a smaller group.

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[30] "The evolution of the international monetary system", remarks by Mark Carney, Governor of the Bank of Canada, to the Foreign Policy Association, New York, 19 November 2009, available from www.bis.org.

64. There is also no agreement on whether or not the present quota formula could be used without modifications. According to many members, the current quota formula falls short of the objective to achieve legitimate representation in the Fund based on a country's economic weight.[31] Accordingly, there have been calls to address the deficiencies in the present formula before it is used as a guide for quota realignment.[32] In particular, there have been proposals to assign a higher weight to GDP, preferably at purchasing power prices, to better reflect the growing role and contribution to global growth of emerging market and developing countries. Many developing countries also insist on adjustments to the measures of variability and openness. Some countries, however, see no merit in reopening the quota formula at this stage as this may significantly delay the completion of the quota and governance review. They support the use of the current formula as the sole basis to determine whether a country is over- or underrepresented.

65. Reaching agreement on these issues requires political will and the strong support of the entire membership to translate reform commitments into reality. Indeed, the very modest 2008 IMF quota and voice reform, which will basically lead to a quota redistribution among the group of emerging market and developing countries, has not yet gone into effect. As at April 2010, only 70 out of the required 112 members, representing 73 per cent of the total voting power (85 per cent is required), had accepted the proposed amendment to the Articles of Agreement to enhance voice and participation in the Fund.[33]

66. The agreement on the second phase of governance reform for the World Bank Group[34] was reached during the World Bank-IMF spring meetings in April 2010. According to the agreement, there will be a small shift in voting power to developing and transition countries in the International Bank for Reconstruction and Development (IBRD), the International Finance Corporation (IFC) and the International Development Association (IDA). For IBRD, the voting power of developing and transition countries was increased by 3.13 per cent, bringing it to 47.19 per cent (representing a total shift of 4.59 per cent since 2008). For IFC, an increase in basic votes and selective capital increase representing a shift of 6.07 per cent (bringing the total to 39.48 per cent) was endorsed. For IDA, the voting share of developing countries would be raised from 40 per cent prior to the start of the reforms to around 46 per cent. These reform targets fall short of the recommendation of the High-level Commission on Modernization of World Bank

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[31] See, for instance, International Monetary and Financial Committee, 21st meeting, 24 April 2010, statement by Timothy F. Geithner, Secretary of the Treasury, United States, available from www.imf.org.

[32] Intergovernmental Group of Twenty-four on International Monetary Affairs and Development, Communiqué, 22 April 2010, available from www.g24.org.

[33] IMF, "Executive Board progress report to the IMFC: the reform of Fund governance", p. 1, 21 April 2010, available from www.imf.org.

[34] The initial package of reforms (phase 1) adopted in 2008 concentrated mainly on the International Bank for Reconstruction and Development and included the doubling of basic votes and the allocation of authorized but unallocated shares to 16 developing and transition countries whose voting power would be reduced by the increase in basic votes. The phase 1 reforms will increase voting power of developing and transition countries in IBRD from 42.6 per cent to 44.1 per cent. It was also decided to add an elected Executive Director for sub-Saharan Africa on the World Bank Group boards.

Group Governance that the balance in voting power in the World Bank should be evenly split between developed and developing countries.[35]

67. At the World Bank-IMF 2010 spring meetings, ministers also reaffirmed their commitment to continue moving over time towards equitable voting power at the World Bank, while protecting the voting power of the smallest poor countries. The next shareholding review is scheduled for 2015. Accordingly, it has been decided to establish a work programme to arrive at a dynamic formula that reflects primarily the evolving economic weight of countries and the development mission of the Bank. Along with the shareholding review, work is under way at the Bank on strengthening Board effectiveness and internal governance, deepening responsiveness to the views of developing and transition countries on development and a merit-based and transparent process for the selection of the President of the Bank.

III. Conclusions

68. The level of net financial transfers of developing countries was notably lower in 2009, reflecting a disorderly unwinding of macroeconomic imbalances. With persistent structural problems underlying the imbalances, the current path of economic recovery is expected to result in an increase in net outward transfers from developing countries.

69. The evolving regulatory framework needs to take due account of systemic risk and the overall stability of the financial system. Financial regulation should be both flexible enough to take into account domestic circumstances and internationally consistent, moving away from regulatory fragmentation.

70. Multilateral surveillance remains at the centre of the crisis-prevention efforts. Along with country-level analysis, it should provide greater coverage of macrofinancial issues, capital flows and systemic risks, including closer examination of members and institutions that are critical for global stability. Assessing international coherence and promoting coordination among national macroeconomic policies should become a chief objective of the multilateral cooperation.

71. There is also a need for close coordination of macroeconomic policy decisions with other areas of global governance. The United Nations has a prominent role to play in ensuring coherent policy responses to interrelated global challenges that cut across the social, environmental and economic spheres.

72. In terms of global financial stability, it is vital to further strengthen the global financial safety net. A critical issue is to find an appropriate balance and develop effective coordinating mechanisms between multilateral, regional and bilateral arrangements and self-insurance.

73. It is important to continue deliberations on the merits and feasibility of moving to a more balanced and stable global reserve system, including an enhanced role for SDRs.

74. The ongoing reform of the governance structures of the international financial institutions offers an opportunity to make important progress on this critical issue. To turn this opportunity into reality, a strong political commitment of Member States is crucial.

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[35] "Repowering the World Bank for the 21st century", report of the High-level Commission on Modernization of World Bank Group Governance, October 2009, available at www.worldbank.org.

Annex

Net transfer of financial resources to developing economies and economies in transition, 1998-2010

(Billions of United States dollars)

	1998	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010[a]*
Developing economies	-40.9	-128.5	-195.4	-164.8	-210.4	-305.1	-380.2	-599.1	-806.6	-872.4	-882.7	-513.3	-641.2
Africa	11.4	0.1	-32.5	-17.9	-5.5	-19.7	-36.2	-79.7	-109.0	-102.4	-108.9	6.1	-33.3
Sub-Saharan Africa (excluding Nigeria and South Africa)	10.6	7.1	2.2	5.7	4.0	5.6	3.3	-3.1	-12.8	-9.3	-1.6	23.7	18.3
Eastern and southern Asia	-128.4	-138.8	-123.3	-119.7	-148.2	-174.4	-182.2	-264.4	-383.9	-519.9	-475.9	-422.3	-438.0
Western Asia	34.5	2.7	-35.3	-29.7	-23.2	-46.7	-76.3	-143.7	-175.6	-144.0	-222.5	-48.4	-112.7
Latin America	41.6	7.5	-4.3	2.5	-33.6	-64.3	-85.5	-111.3	-138.1	-106.1	-75.4	-48.7	-57.3
Economies in transition	0.8	-25.1	-51.5	-32.9	-27.9	-38.0	-62.4	-95.8	-117.1	-96.4	-151.2	-79.6	-126.2
Memorandum item													
Least developed countries	13.7	11.5	6.2	9.4	7.6	9.2	6.4	2.2	-7.0	-4.4	-3.1	27.2	18.4

Sources: Department of Economic and Social Affairs of the Secretariat, based on the *World Economic Outlook April 2010: Rebalancing Growth* (Washington, D.C., International Monetary Fund, 2010) and IMF balance of payments statistics.

[a] Partially estimated.